Cannabis Taxation Memo

Introduction

Staff has proposed that the Board of Supervisors place a Cannabis Business Tax Ordinance on the ballot for the March 7, 2017 special election. The following will summarize the recommended Tax Ordinance before the Board for consideration, the County's authority to tax cannabis businesses under state law, general cannabis tax considerations, operator-specific tax options, taxing medical versus nonmedical cannabis, preliminary revenue estimates and making a permitting ordinance contingent on the voters' passage of a cannabis tax measure.

Recommended Cannabis Business Tax Ordinance Summary

- **Total Estimated Tax Revenue FY 2017-18: $6.3 million**

General

- General tax (no specific expenditures).
- Permits will not be available until the tax is passed or another funding source is secured.
- Enforcement provisions for non-compliance.
  - Non-payment grounds for permit revocation.
  - May require prepayment due to nonpayment or late payment.

Cultivation

- Per square foot based on the maximum square footage under the permit type.
  - Ability to submit evidence of smaller cultivation area or crop loss.
  - License types based on plant count (outdoor cottage and specialty) will be assessed based on an assumed 25 square feet per plant allowed under the permit.
  - Per square foot maximum will increase based on the annual Consumer Price Index (CPI)
- Progressive initial tax rate: lower rate for smaller-scale operators.
- Different square footage rate for Outdoor, Indoor and Mixed light to tax equivalent percentage of revenue.
- Tax at a lower rate initially to incentive compliance, with authority to raise taxes up to the limit.
- Authority to tax up to 10% on gross receipts instead of per square foot.

<u>Tax limit</u>: Estimated tax revenue: $13 million

License type	Operator revenue	Sq. ft. tax	Effective tax rate	Operator tax
Outdoor				
Cottage: 25 plants	$62,500	$10	10%	$6,250
Specialty: 5,000	$500,000			$50,000
Small: 10,000	$1,000,000			$100,000
Medium: 43,560	$4,356,000			$435,600
Indoor				
Cottage: 500	$187,500	$38	10%	$18,750
Specialty: 5,000	$1,875,000			$187,500
Small: 10,000	$3,750,000			$375,000
Medium: 22,000	$8,250,000			$825,000
Mixed light				
Cottage: 2,500	$540,000	$22	10%	$54,000
Specialty: 5,000	$1,080,000			$108,000
Small: 10,000	$2,160,000			$216,000
Medium: 22,000	$4,752,000			$475,200

<u>Starting rates</u>: **Estimated revenue: $5 million**

License type	Operator revenue	Sq. ft. tax	Effective tax rate	Operator tax
Outdoor				
Cottage: 25 plants	$62,500	$0.50	0.5%	$313
Specialty: 5,000	$500,000	$2.00	2%	$10,000
Small: 10,000	$1,000,000	$3.00	3%	$30,000
Medium: 43,560	$4,356,000	$5.00	5%	$217,800
Indoor				
Cottage: 500	$187,500	$1.88	0.5%	$938
Specialty: 5,000	$1,875,000	$7.50	2%	$37,500
Small: 10,000	$3,750,000	$11.25	3%	$112,500
Medium: 43,560	$8,250,000	$18.75	5%	$412,500
Mixed light				
Cottage: 2,500	$540,000	$1.08	0.5%	$2,700
Specialty: 5,000	$1,080,000	$4.32	2%	$21,600
Small: 10,000	$2,160,000	$6.48	3%	$64,800
Medium: 22,000	$4,752,000	$10.80	5%	$237,600

Other Cannabis Businesses Taxation

- Based on gross receipts.
- Authority to tax all operators up to 10%.
- Begin taxing only manufacturers at 5%.

Starting rates: **Estimated revenue: $1.3 million**

		Limits		Starting rates	
Operator	Industry revenue	Tax rate	Tax revenue	Tax rate	Tax revenue
Manufacturing	$26,000,000	10%	$2,600,000	5%	$1,300,000

State Law and Taxation Authority

Under the Medical Cannabis Regulation and Safety Act (MCRSA), local jurisdictions retain broad authority to assess fees and taxes, and are also given explicit taxation authority over cannabis businesses licensed under the law. Any local taxes are subject to a vote of the people, simple majority for a general tax and a super majority for a special tax. MCRSA did not create any new State taxes, though operators have been required to obtain a seller's permit from the State Board of Equalization and have been subject to standard sales and use tax.

Proposition 64 (2016) imposed the first and currently only statewide cannabis businesses taxes. A 15% excise tax is imposed on dispensary (medical) and retail (nonmedical) sales, though medical sales are exempted from the standard sales and use tax (7.5% - 10%). The initiative also imposes a cultivation tax on all cannabis at a rate of $9.25 per ounce for flowers and $2.75 per ounce for leaves.

General Considerations

Based on the County's authority under state law and the costs of implementing a cannabis program, staff has determined that tax revenue is necessary to ensure the General Fund can continue to fund general governmental purposes, such as the implementation of a robust local cannabis program that includes protection of the public health and safety. Through fees the County can recover costs associated with issuing permits, inspections, compliance monitoring, etc. However, taxes may be used to pay for other associated costs related to code enforcement, law enforcement, health impacts and education, environmental cleanup and mitigation, and other costs borne by the County that are not directly attributable to services provided to a permitee.

Tax rates that are too high, however, can encourage the industry operators to remain or return underground. Based on experience in Washington and Colorado, governments should ensure that the combination of state and local taxes not be so high so as to create an incentive to avoid compliance. In Washington, this led the state to reduce its overall tax rate to 37%. In Colorado, a state sponsored study showed that even its 30% cumulative tax rate was too high to sufficiently reduce the black market. As such, the state plans to reduce the current tax rate.

Operator Taxes

Dispensaries

While excise taxes are generally imposed as a flat amount per unit, such as per gallon for gasoline or per pack for cigarettes, taxes for cannabis at the retail level are generally by percent of the sale. This is because cannabis can be sold by ounce, cigarette, or some other varying form. The Tax Foundation's study of Colorado and Washington found that taxes imposed on final retail sales have been the most workable form of taxation. This is because sales by other entities, and thus taxes due, are harder to track. Additionally, taxes at multiple points within the supply chain can unfairly disadvantage companies that are not vertically integrated. This is less of an issue under California law which limits vertical integration, though there are still some allowances for multiple license types within the state and local licensing frameworks.

Cultivation

The primary methods for taxing cultivation are by square foot, gross receipts and product weight. An increasing number of jurisdictions in California have passed or proposed cultivation taxes on a per square foot basis. The main benefit of this tax is that it is easy to assess and track. Most of the cultivation permits under MCRSA are based on an allowable number of square feet for cultivation. Thus, taxes are assessed based simply on the permit the company holds. Cultivators may be opposed to this method because they may choose to cultivate less than the maximum amount allowed under their permit, or they may lose some of their crop (for example, due to pest or weather) and thus owe taxes on a worthless product. The law may have a provision for the cultivator to protest the assessed tax amount and prove unusual circumstances, providing relief while still putting the burden on the cultivator and not the local government.

Gross receipts or product weight, on the other hand, may be deemed fairer by cultivators because they are only taxed on actual revenues collected or product sold. However, under these structures it is much easier for product to evade taxation, presenting a greater enforcement and administrative burden. These concerns may be alleviated by a robust track and trace program that ensures all product is accounted for.

While some states or local jurisdictions may be looking to focus their taxes on the final retail sale, cultivation taxes could be an important source of revenue for Sonoma County. Sonoma County is a producing jurisdiction as opposed to a consuming one. The County grows and exports more cannabis than is purchased at local retail outlets. By only taxing at the retail level and not imposing taxes on cultivation, the revenue collected could be insufficient to cover the costs and mitigate the impacts imposed on the jurisdiction.

Other Cannabis Businesses

The distinct license types enable taxation at many points throughout the supply chain, including support uses such as nurseries, lab testing, distribution and manufacturing. As cautioned above, taxation of these license types can complicate administration, enforcement and collection, and disproportionately advantage integrated companies. Though similar to the benefits of taxing cultivation, Sonoma County has the potential to have a large manufacturing market and is positioned to be a major distribution hub in the industry and thus stands to benefit accordingly from a tax on these operators. Additionally, manufacturing confers an added value onto the product making it an appropriate place in the supply chain to impose an additional tax.

Taxes for nurseries may be imposed per plant, per square foot or by gross receipts. The County's land use ordinance proposes to permit nurseries with a conditional use permit and does not delineate square footage limits within the code. Each CUP could include a square foot limit on which to impose the tax, though these sizes would not be as predictable as for cultivation permits. Other support uses are most often taxed on a gross receipt basis.

Tiered Tax Rates

A tiered tax rate could be implemented to support small businesses. Supporting small businesses was a key component of MCRSA, which limits the size of cultivation operations, limits vertical integration and limits the number of license-types per individual or company. For a cultivation tax based on square feet, the tax per square foot could increase by license which corresponds with a larger cultivation area. Additionally, because indoor and mixed-light operations produce more product, the per square foot rate would be higher for those license types then for outdoor cultivators. Similarly, a tax based on gross receipts could be progressive, increasing the rate on higher revenues.

Tax Rate Phase-in

The tax rate on cannabis businesses may be phased in, starting lower and increasing incrementally over a number of years before reaching the final amount. Initially, there are likely to be substantial startup costs for companies coming into compliance, and a lower tax rate at first could help to offset these expenses and encourage more companies into the light. By proposing this phased approach initially, the jurisdiction need only go to the voters once as opposed to each time it looks to increase the tax rate. Another option is to get approval from the voters to tax at a higher rate and voluntarily tax the industry at a lower rate during the startup phase.

Medical vs. Nonmedical

Many jurisdictions have proposed to tax medical cannabis at a lower rate than nonmedical cannabis. This supports the policy of enabling access, especially to indigent patients. Colorado and Washington have both started with substantially higher tax rates for nonmedical cannabis. As a result, the medical cannabis market has not decreased, whereas initially people had thought that the nonmedical cannabis market would mostly consume it. Prop 64 cites abuse of the medical cannabis system as a reason for legalizing nonmedical cannabis, however, these strong monetary incentives can lead to continued abuse. MCRSA contains many provisions that attempt to curtail abusive practices by doctors and residents, though it is unclear how successful these laws and subsequent regulations will be at reducing unfounded doctors' recommendations for medical cannabis. Taxing nonmedical cannabis can be more thoroughly researched as the County investigates permitting adult use cannabis businesses.

Preliminary Revenue Estimates

The cannabis industry has been largely underground and accurate estimates on its size and value are difficult to determine, particularly for each operator type. In developing permitting regulations, the County has attempted to estimate the amount of production and overall size of the industry, and the revenue estimates below are based on those calculations. The Tax Foundation cautions jurisdictions to not overestimate revenue projections. While the tax revenue can be enormous, other states have found that it takes time to set up infrastructure within the government, get operators out of the black market, and get those operators who are in compliance with permitting to understand the tax expectations.

Revenue estimates for the County are developed from permit interested and estimated revenue per permit type. Based on a survey by the California Department of Food and Agriculture on permit interest in Sonoma County and estimated compliance (25% for cottage and specialty cultivators and 10% for small and medium cultivators), staff estimates that revenue in FY 2017-18 at the proposed starting rates will total approximately $5 million annually from the cultivation tax. The manufacturing tax is estimated to bring in another $1.3 million, for a combined annual revenue of approximately $6.3 million.

Licensing Contingent on Taxation

In 2016, Monterey County adopted both a tax ordinance and a permitting ordinance, the latter of which would only go into effect if the tax was approved by the voters. The County reasoned that without the passage of the tax, it could not afford to allow the industry because it would not be able to cover all the associated costs without cutting other programs. In our online survey staff found that at least 60% of those surveyed would support a tax on medical cannabis, with more support contingent on the reasonableness of the tax rate. To continue to ensure the County is able to fund general government services, staff has recommended that the County make effectiveness of the permitting ordinance contingent on a tax passing or identification of another funding source.

Special Election

Under Proposition 218, an election to impose a general tax must be consolidated with a regular general election at which the members of the governing body will also be elected, unless the governing body unanimously declares an emergency requiring the tax to be placed on another election. (CA Constitution, Article XIIIC, Section 2(b)). Staff finds that the Board could make the required findings to declare an emergency and require the tax to be placed on the March or June election, particularly because the next supervisorial election is not until November 2018.

Other Jurisdictions

Humboldt County

At the November 8, 2016, general election, Humboldt County voters passed a tax measure with 66% approval that imposes the following cultivation taxes: $1 per sq. ft. for outdoor, $2 per sq. ft. for mixed-light and $3 per sq. ft. for indoor. The tax rate for each will be adjusted by an annual consumer price index factor. The County estimates annual revenues at approximately $7.3 million, based on the potential issuance of 400 permits. There were no taxes on other operator types proposed.

Monterey County

This November, Monterey County residents also voted on a cannabis tax measure. The measure passed with 74% approval taxes all operators in the supply chain. The tax will phase in over six years and then be annually adjusted by the CPI for cultivators and nurseries. The effectiveness of its permitting ordinance was contingent on voters passing the tax. The tax is as follows:

Example of Implementation – Year by Year

	Cultivation	Nurseries	All Other Cannabis Business
Year 1 (1/1/2017)	$15/sq. ft.	$2/sq. ft.	5% Gross Receipts
Year 2 (7/1/2018)	$15/sq. ft.	$2/sq. ft.	5% Gross Receipts
Year 3 (7/1/2019)	$15/sq. ft.	$2/sq. ft.	5% Gross Receipts
Year 4 (7/1/2020)	$20/sq. ft.	$3.50/sq. ft.	7.5% Gross Receipts
Year 5 (7/1/2021)	$25/sq. ft.	$5/sq. ft.	10% Gross Receipts
Year 6 (7/1/2022)	$25/sq. ft. + CPI	$5/sq. ft. + CPI	10% Gross Receipts (No CPI)
Year 7 Onward	Prior Year + CPI	Prior Year + CPI	10% Gross Receipts (No CPI)

Mendocino County

Mendocino County approved also approved a tax measure this November with 64% approval that imposed taxes on all operators in the supply chain. The measure imposes a 2.5% business tax on gross sales from cultivation and dispensaries of medical and nonmedical cannabis, which could be raised in increments of 2.5% up to 10%. The measure also imposes a $2,500 annual charge on distributors, transporters, manufacturers, delivery services, nurseries and testing labs.

Santa Cruz County

In November 2014, Santa Cruz County voters passed with 78% approval a measure authorizing counties to tax gross receipts at a rate of no more than 10%, which began at initial rate of 7%.

There are numerous other jurisdictions throughout the State with local cannabis businesses taxes.